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Add-On Accounts: At Best, a Bad Fix for Social Security

by David C. John
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Depending on how they are structured, add-on accounts in Social Security would either force workers to pay twice for the same benefit or end up hurting the very people who most need additional retirement security. These accounts are the direct opposite of President George W. Bush's plan to establish personal retirement accounts in Social Security that would be financed by diverting some of the existing payroll taxes that go to that program.

An add-on account is a retirement account financed either with general revenue from the federal government or some form of additional taxes or forced savings from individual workers. Most opponents of personal retirement accounts (PRAs) say that they do not object to add-on accounts. More recently, some Republicans who worry about the effect of diverting some of Social Security's payroll taxes have latched on to the idea of add-on accounts. They see add-on accounts as having all of the virtues of PRAs without the political cost. But add-on accounts are just as costly as PRAs and must be linked to the existing Social Security system in order to reduce that program's coming cash flow problems.

The different types of add-on accounts are distinguished by where the money for them would come from and how the accounts would relate to Social Security. There are four possible types of add-on accounts. None, however, is an attractive way to fix Social Security.

Voluntary Add-On Accounts

Voluntary add-on accounts would allow workers to invest a portion of their paychecks in new, probably tax-advantaged investment accounts. Incentives to take advantage of these accounts might range from a tax credit for making a contribution to a direct government match of contributions. In practice such incentives would be little more than another government benefit for upper and middle-income taxpayers. Low-income workers would be unable to afford these add-on accounts, just as they tend not to participate in existing employer-sponsored investment plans.

The sad fact is that, faced with the choice between paying the mortgage and saving for a retirement that might happen 40 years in the future if the worker lives that long, many workers choose to meet today's needs. As a result, lower-income and younger workers rarely participate in employer-sponsored retirement plans—even when their employers offer to match some or all of their contributions. It is hard to see how a new system of government-sponsored retirement accounts would change this. If an employer match is not sufficient incentive to save, a government match is unlikely to be any more successful.

How would voluntary add-on accounts affect Social Security? Not at all. While these accounts would allow workers who can afford to save another opportunity to build retirement savings, they would do nothing to save Social Security. In order to improve Social Security's financial situation, a portion of these accounts would have to replace some of the government-paid monthly benefit. It is difficult to see the justice in using part or all of a voluntary account to offset the cost of providing Social Security benefits, when the same offset would not apply to workers who failed to save. Such an offset would be a major disincentive to making these additional, voluntary contributions. In addition, some of the savings that might go into voluntary add-on accounts would come from existing retirement savings vehicles, such as 401(k)s, and so voluntary add-on accounts might not lead to increased national savings. Even worse, there is the problem that low-income workers, who need additional savings the most, would be the least able to participate in these accounts.

Mandatory Add-On Accounts Funded With Additional Mandatory Savings

The money in mandatory add-on accounts could come from required savings, which would probably be collected through the tax system. One way to fund these accounts would be to raise workers' share of the payroll tax by, for example, another four percentage points of income. This additional tax would be called a "contribution" to distinguish it somewhat from other taxes. It would be deposited in an account that the worker would own. An alternate structure might require employers to collect and invest the money, but this would be a significant burden on employers. Their opposition would make passage of such a plan much harder.

The good news about this type of account is that all income levels would participate and have a nest egg available upon retirement. This money would count as new savings in the economy, to the extent that middle- and upper-income workers do not compensate by reducing their existing retirement savings, such as in 401(k) plans. The bad news is that, for lower-income workers, this program would increase their savings by reducing their lifestyles. For families who live from paycheck to paycheck, this could be a problem. For small business owners and the self-employed, the level of forced savings could spell the difference between success and failure.

How would mandatory add-on accounts funded with mandatory savings affect Social Security? It depends. The question is, how much, if any, of the new accounts could be used to replace Social Security's benefits. If the same mechanism that the President proposes to use to prevent "double-dipping" for those who choose PRAs is applied here, the accounts could significantly reduce the system's long-term financial problems.[1] However, such a move would reduce the appeal of add-on accounts, as they would be effectively little more than an increase in workers' payroll taxes to pay for the same benefits.

Mandatory Add-On Accounts Funded by Higher Payroll Taxes

This type of add-on account would require the employer and employee to split the cost of the additional payroll taxes that would go into these accounts. For example, in the case of a four-percent account, both the employer and employee would pay an additional tax equal to two percent of the worker's income that would then be invested in the worker's account. As with a PRA, the worker would probably be able to choose an investment plan from among a few options. The money in these accounts would be new savings, except to the extent that middle- and upper-income taxpayers reduce their other retirement savings.

There are two types of problem with this approach. First, because payroll taxes are a direct tax on employment, some employers would react to the higher costs by reducing employment. A recent Heritage Foundation Center for Data Analysis study showed that a 1.89 percent increase in payroll taxes would result in 277,000 fewer jobs being created in each of the first 10 years after raising the tax.[2]

Raising the payroll tax to fund an add-on account would have the same effect. And because lower-income jobs are the easiest to replace with machines, this reduced employment would hit low-income workers the hardest. This would undermine the goal of improving low-income workers' retirement security.

Workers would experience a lower standard of living as higher payroll taxes lower take-home incomes. This again would probably hurt lower-income workers, who have less flexibility in their household budgets, more than middle- and upper-income workers. Small business owners and the self-employed, who must pay both then employer and employee portions of the payroll tax, would be the hardest hit. For them, the difference in income could be the difference between success and failure.

How would mandatory add-on accounts funded by higher payroll taxes affect Social Security? Essentially, this is a tax increase, with a few advantages. Because this type of account would be funded by the payroll tax, there would be every justification for using them to offset part of the cost of a worker's Social Security benefits. Using the same mechanism that President Bush proposes for PRAs would be likely. However, an increase in benefits would be unlikely, and workers would be limited to receiving the difference between the actual earnings on the accounts and the amount that was used to replace government-paid benefits. This would significantly reduce Social Security's unfunded liability, but at a great cost to workers. Even worse, the low-income workers who need Social Security benefits the most would find it harder to get and keep a job because the higher payroll tax would reduce employment.

Mandatory Add-on Accounts Funded by General Revenue Taxes

The final type of add-on accounts attempts to avoid any controversy about payroll taxes or the Social Security Trust Fund by paying for the accounts from general revenues. With this type of account, the government would essentially give a worker an account equal to four percent, for example, of his or her income. This gift might be described as a refundable rebate of income taxes. The money would come from either higher non-Social Security taxes, such as personal or corporate income taxes, or from borrowing. As with PRAs, workers might be allowed to choose from among a few investment options. Former Social Security Subcommittee Chairman Rep. Clay Shaw (R-FL) has introduced legislation that would create this type of account.

But the problems with this type of account far outweigh the benefits. Because the money appears to be a government gift, Congress could elect to reduce or end the program at any time, much as it ended revenue sharing with state and local governments when deficit pressures got too large. The money would only count as new savings in the economy to the extent the accounts were financed by higher taxes. Borrowing the money, such as Rep. Shaw suggests, would only shift money around in the economy and would eventually require higher taxes to repay the borrowing.

How would mandatory add-on accounts funded by general revenue taxes affect Social Security?As proposed by Rep. Shaw, workers would essentially pay twice for the same benefit. Under his bill, a worker is guaranteed the higher of either the monthly benefit paid from his account or what Social Security promised to pay, but not both. In practice, this means that most or all of the account would be seized by the government and used to pay the Social Security benefits previously paid for by payroll taxes—which workers would continue to pay. In this sense, Rep. Shaw's plan is little more than a massive general revenue subsidy for the existing Social Security system, dressed up as individual accounts. While this plan would address Social Security's cash-flow problems, once the borrowing needed to fund the accounts come due, a delayed tax increase would be inevitable. General-revenue accounts, then, would do little more than shift the burden of Social Security a bit into the future and to a slightly different revenue source.

Conclusion

Politicians who think that add-on accounts are a “magic bullet” that would fix Social Security without the cost or political risk of real personal retirement accounts should think twice before supporting add-on accounts. This is especially true for legislators who claim to represent the interests of low-income workers.

The add-on accounts that are guaranteed to help Social Security are little more than tax increases disguised as personal counts. Other types of add-on accounts would mainly benefit upper and middle-income workers and do little to help the workers who need additional retirement security the most. Workers at all income levels would be better served by real personal retirement accounts, such as those proposed by President Bush.

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[1] See David C. John, “PRA Basics: How the President’s Plan Prevents Unfair Double-Dipping,” Heritage Foundation WebMemo No. 654, February 5, 2005, at http://www.heritage.org/Research/SocialSecurity/wm654.cfm.

[2] Rea S. Hederman, Jr., William W. Beach, and Andrew Grossman, “The Unacceptable Costs of Raising Payroll Taxes to ‘Save’ Social Security,” Heritage Foundation Webmemo No. 639, January 13, 2005, at http://www.heritage.org/Research/SocialSecurity/wm639.cfm .